Implementation of Basel II: Regulatory and Supervisory Challenges

Dr. Tarisa Watanagase
Deputy Governor, Bank of Thailand

Seminar on Policy Challenges for the Financial Sector
Washington DC
June 2, 2004

Good morning. I am very honoured to participate in this seminar with such distinguished participants and I thank the organizers for inviting me.

Given the 15-minute time limit, I will try to highlight only some key issues which I think are perhaps more relevant from the emerging markets' perspectives.

As we all know, since the New Accord consultative papers have been released for comment, it is usually the Pillar I--in particular the IRB approaches and their technical complexities--that has attracted most of the attention, not least in emerging market economies.

While the IRB approaches are indeed a major conceptual leap from the current accord, it seems to me that for emerging market economies to focus their attention on Pillar I, especially the IRB approaches, right now might not be the best use of time and resources.

For one thing, I believe the most pragmatic approach in the next few years for banks in most emerging market economies, including Thailand, will be to adopt the standardized framework for credit and operational risks. It will take quite some time for pre-requisites of the IRB approaches to be met by financial institutions in these countries, especially in the areas of data quality and risk management practices.

For another thing, calculating minimum capital requirements under the standardized approach to Pillar I will not be such a radical change from the current accord (with the exception of risk-weights assigned to retail and past due credits). This is because of the dearth of rating agencies in emerging market economies due to underdevelopment of the local bond market. Therefore, there are very few rated companies; and virtually all corporate borrowers will be assigned 100% risk weight.

Therefore, as far as most emerging market economies are concerned, the standardized approach under Pillar I will <u>provide only rough proxies of risks</u> that may not necessarily reflect an institution's true risk profile --be it credit, operational, or market risks.

Neither does Pillar I capital charge take account of <u>other material banking risks</u> which include, for example, interest rate risks in the banking book, liquidity risk, credit concentrations, and strategic risk.

Finally, Pillar I, under the standardized approach, does not provide us with any insights regarding an institution's <u>risk management quality.</u>

For these reasons, regulatory capital requirements under Pillar I should not be taken as a substitute for the proper analysis of an institution's capital adequacy. Instead, it magnifies the need to focus efforts on building a robust Pillar II supervisory review process to ensure that capital is better aligned with true underlying risks taken by banks.

In my opinion, the proper implementation of Pillar II might be the single most important issue for most emerging market economies adopting the New Accord because it involves a critical evaluation of existing legislative, regulatory, and supervisory practices.

Only under Pillar II can the supervisors properly assess an institution's overall risk profile: that is its actual exposure to credit, operational, market, and other material banking risks; the adequacy of balance sheet provisions; the quality of risk management practices; and an assessment of capital adequacy based on this understanding.

In order to arrive at proper risk assessments, our supervisory staff must possess the requisite conceptual, analytical, and judgmental skills. And, it is this uncertainty surrounding "supervisory judgment" that makes Pillar II so challenging to implement in practice.

For example, how do we as policy makers ensure a consistent application of Pillar II given that supervisory judgment varies among individual supervisors? How do we ensure discipline in the provisioning process so that asset values and reported capital ratios are not overstated? How do we address other material banking risks mentioned earlier ?

At the Bank of Thailand, we have attempted to address some of these critical questions, in part, by setting appropriate prudential standards and by developing "risk-focused" on- and off-site inspection manuals that provides each supervisor with a structured approach to risk analysis, while preserving the importance of supervisory judgment.

This is very much a work in progress, and we still have substantial work ahead. Let me give you one concrete example: We are in the initial stages of developing prudential standards on interest rate risks in the banking book – which is probably one of the more contentious issues under Pillar II. However, it is not enough to simply draft broad "best practices" standards for the industry. Rather, we must support these prudential standards with practical examination guidance and extensive training to equip our front-line supervisors with the necessary tools to implement this in practice.

Let me now turn your attention to some of the changes in the legal framework that may be needed in many countries in order to fully implement the principles noted under Pillar II.

For example, if the legal framework does not allow the supervisory authority to seek capital in excess of the minimum regulatory requirements, which necessarily differ from one bank to another, then the usefulness of the on- and off-site supervisory review processes will clearly be undermined.

Similarly, “risk-based” supervision cannot be fully effective if supervisors do not have the power to intervene at an early stage, even when banks meet or exceed minimum Pillar I capital requirements.

At the Bank of Thailand, we have proposed a financial institutions law to Parliament that will give us the necessary legal powers to implement the principles noted in Pillar II. Once the new law is passed, the challenge going forward will be how we exercise these powers in practice.

Our discussion on the new capital accord would not be complete without some mention of Pillar III.

As you are well aware, many countries --both developed and developing-- have at one time or another resorted to the use of blanket deposit guarantee as a means to stem systemic financial crisis. Obviously, until such blanket guarantee is lifted or replaced with a limited deposit insurance, market discipline will not work no matter how much disclosure is required.

Second, even without a formal blanket guarantee, the general public often assume that it is the government’s moral responsibility to protect their savings from bank failures and thus there is implicitly a *de facto* blanket guarantee. Unless and until this deeply rooted mindset is changed, it will be difficult to foster an effective market discipline through greater disclosures.

Third, we must also strike a proper balance between the costs imposed on the industry associated with greater market disclosures vs. the benefits of additional disclosures. Here we must attempt to distinguish between what market participants “need to know” vs. what would be “nice to know”. Even items that on the surface may be categorized as “need to know” are not so straightforward. For example, is it prudent to disclose that a bank is under a formal capital directive or other regulatory enforcement action? While one can make a strong argument that such information is critical for market discipline to work in practice, others can also argue that if the information is not used properly, it can lead to highly undesirable consequences – such as a bank run.

These are the issues we will be grappling with in the years ahead.

In conclusion, I would like to leave you with three thoughts.

First, the traditional thinking in many countries about capital adequacy must change.

The notion that a bank is safe and sound simply because it adheres to minimum regulatory capital requirements must be abandoned. We must impress upon the

banking community that adopting sound risk management practices goes far beyond adhering to numerical ratios prescribed by regulators. The essence of Basel II is about encouraging sound risk management practices and fostering risk-based supervision. Going forward, financial institutions' view of supervision in general, and capital adequacy in particular, must be in line with this philosophy, rather than as solely a regulatory compliance issue.

Second, we need to be mindful that being "Basel II compliant" is far more complex than merely adopting a particular approach under Pillar I and enhancing market disclosures. As we all know, being Basel II compliant really entails compliance with the 25 Basel Core Principles as well as the preconditions for effective bank supervision.

This led to my last point: The international community--including the standard setters--should begin to focus less on Pillar I and redirect their efforts and resources more on Pillar II, so that supervisors and bankers alike will better recognize the importance of, and the challenges related to, the proper implementation of the supervisory review process. At the end of the day, what matters most is <u>not</u> what capital regime a country adopts, but the *quality* of day-to-day supervision. In this regard, we must work in partnership with the international bodies to tackle these formidable challenges today, in order to build a more safe and sound banking system in the future. Thank you for your attention.